

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201052004**

Release Date: 12/30/2010

CC:PA:06:GTArmstrong
POSTF-126169-10

UILC: 9111.09-00

date: August 27, 2010

to: Yvonne Walker
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from: Susan T. Mosley
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(Procedure & Administration)

subject: Duty of Consistency as Applied to Form 1120SF

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Company A =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

a =

ISSUE

Whether the Service may assert the doctrine of duty of consistency to preclude a receiver from claiming certain deductions on a settlement fund's return that were

previously taken and allowed on a partnership return for which the period of limitations on assessment has now expired.

CONCLUSION

Yes. The Service may assert the doctrine of duty of consistency to preclude a receiver from claiming deductions on a settlement fund's return that were previously taken and allowed on a partnership return for which the period of limitations on assessment has expired.

FACTS

In Year 1, the United States government filed suit against Company A, a partnership for federal income tax purposes, for its role in an alleged Ponzi scheme. The court hearing the government's complaint entered an order appointing a law firm as receiver of the partnership's assets. The court ordered the receiver to gather the remaining assets of the partnership, to conserve them, and to ultimately utilize them to satisfy claims filed by investors who had filed suit against the partnership. Accordingly, the receiver established a settlement fund consisting of income generated from the partnership's remaining legitimate business activities and interest earned on that income.

As part of its fiduciary duties, the receiver also handled the filing of the partnership's income tax returns starting with tax year Year 1. Though not a partner or member of Company A, the receiver signed the partnership's returns as the tax matters partner. On returns filed for Year 1 through Year 2, the receiver caused the partnership to deduct expenses relating to the partnership's business operations. The receiver also caused the partnership to deduct expenses incurred by the receiver in gathering and conserving the partnership's assets (the "disputed expenses"). Furthermore, the receiver determined that the interest accrued by the settlement fund was not includable on the partnership's income tax returns. Apparently, the receiver believed that this interest was more properly reportable on Form 1099's that the receiver intended to provide to investors who would receive the settlement payments. The receiver never issued any Form 1099's, however, and as a result, the interest that accrued on the settlement fund was never reported to the Service.

In Year 3, the receiver began making settlement payments to the claimant-investors who had filed suit against the partnership.

In Year 4, the receiver contacted the Service and confessed to the unreported interest from the settlement fund account, estimating that over \$a had never been reported on any return filed with the Service. It is our understanding that these interest amounts should have been included on Forms 1120-SF, U.S. Income Tax Return for Settlement Funds (the "QSF returns"), which the receiver should have filed for each year the settlement fund was in existence. Furthermore, had the QSF returns been timely filed, the receiver could have properly deducted the disputed expenses relating to its gathering and conservancy duties.

We understand the receiver has agreed that it should have filed the QSF returns in addition to the partnership returns. Furthermore, the receiver agrees that it should have reported the interest from the settlement fund on the QSF returns. The receiver now, however, also seeks to include, as deductions on the QSF returns, the disputed expenses. The receiver deducted these same expenses on the partnership returns filed in tax years Year 1-Year 2. The period of limitations on assessment with respect to the partnership returns has expired. The receiver alleges, however, that it should be entitled to deduct the disputed expenses regardless of their inclusion on the Year 1-Year 2 partnership returns. To conclude otherwise, argues the receiver, would penalize the recipients of the settlement payments because the settlement fund would bear the burden of the additional income tax (resulting from the disallowed deductions).

LAW AND ANALYSIS

For the reasons set forth below, we conclude that the Service may assert the doctrine of duty of consistency to preclude the receiver from deducting the disputed expenses on the QSF returns.

The duty of consistency is an equitable doctrine that Federal courts will employ to prevent “unfair tax gamesmanship.” Hollen v. Commissioner, T.C. Memo. 2000-99; Cluck v. Commissioner, 105 T.C. 324 (1995). The doctrine “is based on the theory that the taxpayer owes the Commissioner the duty to be consistent . . . and will not be permitted to benefit from the taxpayer’s own prior error or omission.” Cluck, 105 T.C. at 331. The doctrine requires proof of three elements: (1) the taxpayer has made a representation in one year; (2) the Service has acquiesced in or relied on that representation for that year; and (3) the taxpayer desires to change that representation in a later year at a time when the period of limitations bars adjustments to the prior year. See id. at 332; LeFever v. Commissioner, 103 T.C. 525, 543 (1994).

As set forth in your request for assistance, it appears that the traditional three-prong test is met in this case. First, the receiver caused the partnership to take certain deductions on the partnership’s return relating to expenses incurred by the partnership and by the receiver. Second, the Service relied upon the partnership’s representations on these returns. Third, the receiver now seeks to cause the settlement fund to take deductions for the same expenses (that is, those expenses relating to duties performed by the receiver) on the QSF returns, which the receiver should have filed, but did not, when it filed the partnership returns. For the years relevant here, the statute of limitations on assessing the partnership returns is no longer open. Therefore, under a traditional analysis, it seems the Service can preclude the receiver from causing the settlement fund to take deductions on the QSF return for the disputed expenses previously deducted on the partnership’s return. This fact pattern, however, presents an issue regarding whether the partnership and the settlement fund can both be considered the “taxpayer” whose duty it is to be consistent. While we believe these entities to be two

separate taxpayers, we conclude that the representation by one can estop the other in this case.

First, with respect to the partnership return, the partnership files an information return (although the partnership itself is not liable for any tax). See I.R.C. § 6031(a) (Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and allowable deductions.). With respect to the QSF return, the settlement fund is the taxpayer and must file an income tax return (and is ultimately liable for any taxes due). See Treas. Reg. § 1.468B-2(k)(1) (A qualified settlement fund must file an income tax return with respect to the tax imposed . . . for the taxable year that the fund is in existence.). With respect to both returns in this case, however, it is the receiver that is responsible for preparing and filing the returns, regardless of the identity of the taxpayers. The receiver controls how items are reported, and therefore, it is the receiver who is charged with the duty to be consistent in this case.

Indeed, a number of courts have held that, under certain circumstances, a taxpayer may be estopped by a representation made by or on behalf of a related taxpayer. See, e.g., Cluck v. Commissioner, 105 T.C. 324 (1995); Beltzer v. United States, 495 F.2d 211 (8th Cir. 1974); Hess v. United States, 537 F.2d 457 (Ct. Cl. 1976). These courts have based their findings on the existence of a “sufficiently close relationship between the party making the representation and the party to be estopped.” Cluck, 105 T.C. at 335. The sufficiency of the closeness of this relationship will depend upon on the facts and circumstances. Id.

For example, in Beltzer, the Eighth Circuit Court of Appeals held that a beneficiary was bound by representations made on the estate’s tax return. On that return, which the beneficiary son signed as co-executor of his father’s estate, the estate reported certain stock at its fair market value at the time of the father’s death. The son, after receiving the stock in a distribution from the estate, sold it for a significant sum and used as his basis a value much higher than that reported on the estate’s return.¹ Because the period for adjusting the estate’s return had expired, the Service argued that the duty of consistency doctrine precluded the son from using a different value than that reported by the estate. The court agreed with the Service and found that the son was bound by the values reported on the estate’s return.

Similarly, in Hess, the Court of Claims concluded that the duty of consistency precluded a testamentary trust from claiming a basis in certain stock that was different from the value of the stock as reported on the estate’s return. Though the court noted that the estate and trust were “separate legal entities,” it concluded: “The interests of the two entities being very closely related, and the same individual having acted, we think it only fair and in accord with the spirit of the law, to require the trust to act in a manner

¹ Pursuant to section 1014, the basis of the property acquired from a decedent is generally the fair market value of the property at the date of the decedent’s death.

consistent with the estate.” Hess, 537 F.2d at 464. The phrase “the same individual having acted” referred to the fact that the same individual, Mr. Hess, operated as a trustee of the testamentary trust as well as an administrator of the estate. In those capacities, Mr. Hess filed returns for both entities in which the stock at issue was reported at two different values.

Lastly, in Cluck, the Tax Court considered whether the duty of consistency could bind a petitioner to certain values agreed upon by the petitioner’s husband in a stipulation of settled issues. Petitioner’s husband entered into the stipulation in an earlier case in which he and the Service agreed on the value of certain property for purposes of determining the tax liability of his mother’s estate. After receiving that property in a distribution from the estate, petitioner’s husband sold the property and recognized capital gains. Those gains reduced net operating loss (NOL) carryforwards claimed by the husband and the petitioner on their joint income tax return. The petitioner challenged the Service’s adjustments to the NOL carryforwards, claiming she was not bound by the husband’s stipulation and that she had a higher basis in the property. The Service argued that the duty of consistency applied and the court agreed, finding the relationship between petitioner and her husband “sufficiently close” to bind the petitioner. In effect, the husband’s representation in the prior year’s stipulation, upon which the Service relied, estopped the wife from taking a different position on a later return.

Similarly, here, the partnership’s representations on its return, upon which the Service relied, bar the settlement fund from taking deductions for the same expenses on its own income tax return. Though the partnership and settlement fund are two separate legal entities, their relationship is “sufficiently close” in this case that the actions of one may bind the other. In addition, as in Hess, the same entity (the receiver) controls how both the partnership and the settlement fund report items on their respective returns. The receiver, similar to the estopped beneficiary in Beltzer, will sign the return of the settlement fund as administrator and, in the case of the partnership’s return, has signed the return as the tax matters partner. Because of the sufficiently close relationship of the two entities and the fact that the receiver controls and signs, or has signed, returns for both, the partnership’s representations on its returns for the Year 1-Year 2 tax years should bind the settlement fund.

Were it not for the unique role of the receiver, we would certainly agree that, under a traditional duty of consistency analysis, the settlement fund would be barred from deducting the disputed expenses. Your question, however, presents the unique issue of whether a partnership’s representations can bind a related settlement fund with respect to the fund’s own income tax return. Here, the receiver caused the partnership, over which it had control through decree of the court, to file tax returns and claim deductions for expenses incurred by the receiver in carrying out its fiduciary duties. The receiver now wishes to cause the related settlement fund to deduct the same expenses on returns which the receiver neglected to timely file on behalf of the settlement fund.

We conclude that the Service may assert the doctrine of duty of consistency to preclude the receiver from doing so.

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Please call (202) 622-7950 if you have any further questions.